DFI SPY for CREDIT UNION$

Spring 2000

KENTUCKY DEPARTMENT OF FINANCIAL INSTITUTIONS

Regulatory News for Kentucky's State-chartered Credit Unions

BETTER COMMUNICATION GOAL OF NEWSLETTER

Welcome to the first annual newsletter by the Department of Financial Institutions that is devoted entirely to credit unions. The objective of this newsletter is to improve communication between the Department and the credit unions it regulates. We hope you find this newsletter educational, beneficial, and enjoyable.

NEARLY HALF STATE CREDIT UNIONS FAIL TO REPORT

As you are probably aware, each federally insured credit union is required to provide the Department of Financial Institutions and the National Credit Union Administration annually with a list of their officials. However, forty-five percent of the state-chartered credit unions did not turn in the report of officials as required.

If you cannot locate the disk provided by the NCUA, you can download the report of officials program from the NCUA website at www.ncua.gov.

INSIDE

Printed with State Funds

Simplifying Credit Union Loan Writing Can Be Risky

CUNA Mutual has developed a wonderful product for lessening the burdens of repetitious loan document writing. The loan liner system allows credit unions to open one loan line and allows draws for each loan product offered. The catch with this is that each loan product and its available interest rate must be disclosed on the initial loan liner addendum offered for truth-in-lending disclosure requirements. The loan liner manual presented to credit unions describing how the forms are completed contains the catch-all phrase, "Management must determine if it meets the individual State disclosure requirement." It is very easy to fall into the trap: If CUNA sold it, it's okay. Many times during loan review, special loan program rates and teaser rates are not disclosed on the disclosure addendum. This creates a truth-in-lending violation. Many institutions make closed-end loans on these open-end forms, another truth-in-lending problem. Management should familiarize themselves with the requirements of Regulation Z covering interest rate disclosures.

CUNA has incorporated these open-end forms for real estate loans. Again, the credit union must determine the adequacy of these disclosures for Kentucky's statutory requirements. The federal disclosure requirements of RESPA, Regulation Z, and the Fair Housing Act are mandatory for each loan officer to research and understand. Disclosure problems can have devastating effects on institutions, and adequate disclosure is fundamental. These products are very good for credit unions, but their accuracy is required, and CUNA will not complete the forms, so each credit union must do this correctly.

The Call Report BLOOPER Of The Year

One credit union did not list an amount for the NCUSIF. Do we now have private insurance in Kentucky? Not yet, but wishful thinking.

THREE LEGAL OPINIONS HELP CLARIFY PROCESS

The Department rendered three legal opinions related to Credit Unions in 1999. A synopsis of each opinion follows.

1. Re: KRS 290.525(1)(b)/Loans to Insiders

Can the power to review and approve insider loans be delegated to the appointed Credit Manager provided that the loans are subject to strict underwriting guidelines as established by the Board of Directors' loan policy, and provided that the Board of Directors reviews and approves these loans at its next scheduled meeting? The short answer is "no." The Department has permitted a Board of Directors to review the financial information for one or several officers and approve a loan amount in advance. In this manner, the Board has reviewed and approved the loan ***in advance*** of the time it is made rather than after the fact. In the event that an officer with a pre-approved loan wishes to borrow more than the approved amount, he or she would have to secure advance approval of the Board and could not rely on the pre-approval.

2. Re: E-mail meetings unlawful

Can meetings (Executive Committee) be conducted by e-mail? The short answer is "no." Any electronic "meeting" would have to involve a gathering of participants ***in real time***, i.e. simultaneous communication. That can be done with modern technology through something akin to a "chat room" but ***not*** through e-mail. Therefore, the credit union may lawfully conduct its meetings pursuant to KRS 290.245 electronically (i.e. by "chat room") but the participants must all be on line ***simultaneously***. E-mail and regular mail exchanges do not constitute meetings under Kentucky law. KRS 290.245 specifies that the directors shall ***meet***. KRS 271B.8-200(2), which governs corporations in general, requires that the meeting occur in real time. Although electronic meetings can be held under proper circumstances, meetings of the Executive Committee may ***not*** lawfully be conducted by e-mail.

Or

KRS 290.245 mandates that the Executive Committee conduct business through meetings. While KRS 271B.8-200(2) permits these kinds of meetings by conference call (or videoconferencing), it also requires that the participants in the meeting be able to "***simultaneously*** hear each other during" the meeting. E-mail does not allow for ***simultaneous*** communication, and therefore it can not be used as a medium for Executive Committee meetings under KRS 290.245 or KRS 271B.8-200(2).

3. Re: More Periodic Statements will help

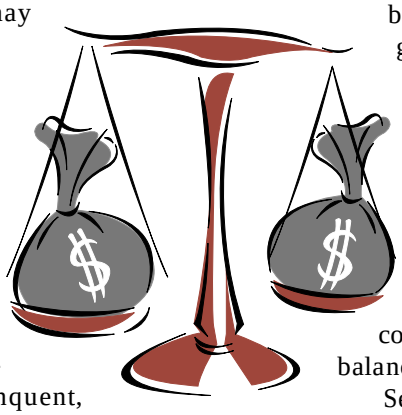
Can statements only be provided over the Internet, i.e., not paper? Banking law can be used by analogy to answer the question. Under KRS 355.4-406 of the UCC, a bank is not required to send a periodic statement of account to the customer. However, if it does not, the customer does not have a duty to reasonably discover any unauthorized payment, and the bank cannot avail itself of the one-year statute of limitation for any liability therefore. Thus, it would behoove a bank to see to it that the customer gets periodic statements so that the bank can start the clock running on mistakes. The same would hold true for a credit union. It would be lawful for a credit union to elect to send only an annual statement (regardless of whether the member has access to view their accounts/loans through Home Banking or some other equivalent program) ***provided that the credit union stood ready, willing, and able*** at any time to deliver a statement for a lesser period (i.e. a month or a quarter) upon request from a member.

Here is a synopsis of the opinion itself.

It would be lawful for a credit union to elect to send only an annual statement if the member has access to view his accounts/loans through Home Banking, or some other equivalent program ***provided that the member consented to the arrangement and the credit union stood ready, willing, and able at any time to deliver a statement for a lesser period*** (a month or a quarter) upon request from a member. Nothing in the Kentucky law prohibits such a consensual arrangement with a customer. The member must ***consent*** to the arrangement. A rule unilaterally imposing a paperless statement, as a condition of Home Banking, would suffice as a substitute for an affirmative election.

IS YOUR ALLOWANCE FOR LOAN LOSSES PROPERLY FUNDED?

A common problem during examinations is finding the Allowance for Loan Losses account to be underfunded. Improper reviews by staff may also result in funding the account by less than what is required. The manager using the following procedures should review the account at least quarterly.



First, the manager should review the methodology established by the Board of Directors. An in-depth study should be made of current delinquent loans and their loss potential as determined by management. Some credit unions assign 10% to balances two months delinquent, 25% to balances three months delinquent, 50% to balances four months delinquent, 75% on balances five months delinquent, and 100% of balances six months or more delinquent. In addition, the loss could be adjusted by collateral, if any, that would be sold. This determination must conform to the methodology established by the Board. Consideration should also be given to any potential loss situations that may not be delinquent such as bankruptcies filed, vehicles repossessed, etc.

The credit union should maintain a calculation of its historical loan loss. This is determined by dividing net loan losses by average loans. Consideration should be given to determining both the three-year and five-year historical ratio and to using the more conservative approach to determine the required balance for the account.

Second, the amount of total loans classified individually would be subtracted from the total loans outstanding. The credit union's historical loss factor would then be applied to the remaining or non-classified loans.

Example:

Year	Loan Balance	Average Loans	Net Loan Loss	Factor	
1999	2,425,000	2,550,000	10,200	.004	(Net Loan Loss / Average Loans)
1998	2,675,000	2,577,500	10,310	.004	
1997	2,480,000	2,490,000	-4,980	-.002	
1996	2,500,000	2,425,000	7,275	.003	
1995	2,350,000	2,175,000	4,350	.002	
1994	2,000,000				

Total Loans $2,519,000
Total Delinquent Loans $7,647
Total Classified Amount $2,300

If the credit union has an Allowance Account balance of $5,500 are they overfunded or underfunded?

Go to page 4 for the answer.

GOOD NEWS ON LEGISLATIVE ISSUES

Legislation has passed both the House and Senate relative to KRS 290.525 that will increase from ten thousand dollars ($10,000) to twenty-five thousand dollars ($25,000) the loan amount which a credit union may make to its officials without board approval. Legislation was also passed on KRS 290.585 to increase from ten percent (10%) to twenty percent (20%) the maximum percentage that may be invested in shares or deposits of credit unions. This will allow smaller credit unions to maintain more investments with corporate credit unions. Once signed by the Governor, the effective date of the new law will be July 15, 2000.

GOLF TIP OF THE DAY

Get Lessons...

LIEN FILING A MUST WITHIN TWENTY DAYS

Prompt filing of liens is now a must. Secured lenders must file lien applications on secured loans within the 20 days established as the federal perfection period or face having their security interest voided.

In other words, according to a 1997 Supreme Court ruling, urgency is now required in filing liens. Credit union personnel responsible for the paperwork needed to perfect a security interest must ensure that the lien is perfected promptly. Delay could easily result in having the credit union's interest in a secured loan rejected, forcing it to share the value of the asset with other general creditors.

In *Fidelity Financial Services, Inc. vs. Fink*, the debtor purchased a new car and gave Fidelity a promissory note for the purchase price secured by the car. The lien was perfected 21 days later, within the 30 working days allowed to perfect its security interest under Missouri law.

The debtor subsequently filed for bankruptcy and the bankruptcy trustee, Richard Fink, moved to set aside fidelity's security interest. The lien was a voidable preference under 11 U.S.C. Section 547(c)(3)(B), claimed Fink. "Section 547 prohibits the avoidance of a security interest for a loan used to acquire property if, among other things, the security interest is perfected on or before 20 days after the debtor receives possession of such property," wrote Justice David Souter.

Fink argued that the enabling loan exception was inappropriate because Fidelity hadn't perfected its interest within the 20-day period. Fidelity countered that Missouri law treats a motor vehicle lien as perfected on the day it was created if the creditor files the necessary documents within 30 days after the debtor takes possession.

The bankruptcy court set aside the lien as a voidable preference, holding that Missouri's relation back provision couldn't extend the federal 20-day perfection period. This opinion was upheld in district court and in the 8th Circuit U.S. Court of Appeals, which held a transfer to be perfected when the lender takes the last step required by state law to perfect its security interest.

In most cases, problems in this area arise with indirect lending through auto dealers. Credit unions need to be certain that the dealer is doing it right. Problems usually stem from dealers sitting on paperwork.

NEW COMPUTER PROGRAM TO GREATLY IMPROVE EXAMS

Beginning in March, the NCUA will begin training examiners on the new examination platform and issuing new computers and printers. AIRES 2000 combines a database, excel worksheets, and word documents that work together to provide a significantly improved and more efficient examination.

In order to fully utilize the power and efficiency of the new examination, share and loan download capabilities are necessary. While the majority of credit unions are already providing examiners with share and loan downloads, there are still some credit unions that do not provide this information either because of the vendor or the cost.

The Department has a new policy regarding share and loan download information. If your vendor is capable of providing you with a download, you are expected to provide this data during the examination. The Department has determined that cost, or charges by the vendor, is not a valid reason for not providing examiners with a share and loan download.

answer from page 3

OVERFUNDED OR UNDERFUNDED?

The sum of the five-year factors is .010 divided by 5 is .002. To determine adequacy of the Allowance we subtract classified loans from loans outstanding. $2,519,000 - $7,647 = $2,511,353 multiplied by the five year loss factor of .002
$2,511,353 X .002 = $5,022.71

To this amount we have the classified amount of $2,300 giving a total Allowance requirement of $7,322.71.

Remember, the Allowance for Loan Losses must be properly funded **prior to** the payment of dividends.

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